

DEC 2

District Director, Chicago, Illinois

Assistant Chief Counsel (Income Tax and Accounting)  
Chief, Branch 5

Request for assistance in the Determination Letter Request for  
[REDACTED]

This memorandum responds to your request for assistance in the above-referenced determination letter request. The Taxpayer, P, requests several determinations involving sections 1033 and 1502 of the Internal Revenue Code. Specifically, P requests that you make the following determinations:

- 1) the proposed purchase by P of real property from S will constitute the purchase of qualified replacement property pursuant to sections 1033(a)(2)(A) and (g);
- 2) pursuant to section 1033(a)(2)(A), gain will be recognized by P only to the extent that the amount realized upon the involuntary conversion of Land exceeds the cost of such replacement property;
- 3) P's basis in the acquired replacement property will be its cost as determined under section 1012 of the Code and section 1.1502-31(a) of the Treasury Regulations, as adjusted by section 1033(b);
- 4) the sale of property by S to P will constitute a deferred intercompany transaction under section 1.1502-13(a)(2)(i) of the Treasury Regulations.

FACTS

P

=

[REDACTED]  
EIN [REDACTED]

S

=

[REDACTED]  
EIN [REDACTED]

A1

=

[REDACTED]  
EIN [REDACTED]

A2

=

[REDACTED]  
EIN [REDACTED]

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A3 = [REDACTED]  
EIN [REDACTED]

T = [REDACTED]  
EIN [REDACTED]

Partnership C = [REDACTED]

Land = various parcels of land owned by P, A1, A2, and A3 that were taken by condemnation or under Federal reclamation laws in [REDACTED] and [REDACTED]

y = [REDACTED]

[REDACTED] x = [REDACTED]

[REDACTED] x = [REDACTED]

[REDACTED] x = [REDACTED]

[REDACTED] x = [REDACTED]

P is the common parent of an affiliated group filing a consolidated tax return on a calendar year basis. P's business includes acquiring, developing, and managing real estate for industrial, office, and retail income-producing purposes. Acquired property found to be unsuitable for development is sold. P was wholly-owned indirectly by T, another parent of an affiliated group until [REDACTED] and then directly owned by T until [REDACTED]. Corporations A1, A2, and A3 are also part of T's affiliated group.

During [REDACTED] and [REDACTED], various property ("Land") owned by P, A1, A2, and A3 was taken by condemnation or sold pursuant to the Federal reclamation laws. The four corporations received combined conversion proceeds of approximately \$[REDACTED]x of which \$[REDACTED]x represented realized gain. They elected to defer the recognition of gain under section 1033(a) of the Internal Revenue Code on T's consolidated tax returns for [REDACTED] and [REDACTED]. In [REDACTED], A1, A2, and A3 merged into P and disappeared. As a result of this merger, the conversion proceeds received by A1, A2, and A3 became the conversion proceeds of P under section 381(c)(14) of the Code.

In mid-[REDACTED], T acquired [REDACTED]% of P's outstanding stock as a stock dividend from one of its subsidiaries. Also, in [REDACTED], P issued \$[REDACTED]x in convertible debentures and y% of its unissued common stock for \$[REDACTED]x to Partnership C. As a condition

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debentures from Partnership C if certain events did not occur by [REDACTED]. Partnership C required that P pledge enough assets protected from other creditors to meet this obligation. To satisfy Partnership C's requirements, P formed a wholly-owned subsidiary, S, and contributed various properties approved of by Partnership C to the subsidiary. S's stock was then pledged to Partnership C. At that time, P had no intention to reacquire those assets from S.

Now, P proposes to reacquire some of the contributed assets that are like kind to the converted Land from S at a purchase-price reflecting fair market value as determined by an independent appraiser. P intends to pay for the property with cash ([REDACTED] % of the purchase-price) and a nonrecourse promissory note ([REDACTED] %). The promissory note will be secured by the acquired property, will bear interest at a commercially reasonable rate, and will require semi-annual interest payments. It will have a fixed maturity date and will contain other attributes commonly found in instruments issued by unrelated parties. Similarly, the purchase contract will contain the typical standard warranties, representations, covenants, etc. which are normally found in real estate purchase contracts entered into by unrelated parties.

P makes the following specific representations:

- 1) Land was held by P, A1, A2, and A3 for investment or for productive use in a trade or business, and not for sale to customers in the ordinary course of business;
- 2) Land was involuntarily converted within the meaning of sections 1033(c) and (g)(1);
- 3) P, A1, A2, and A3 properly and timely elected to defer the gain realized upon the involuntary conversion of Land on T's consolidated federal income tax returns for the years in which the involuntary conversions occurred;
- 4) the proposed purchase of the replacement property from S will occur within three years of the close of the first taxable year in which any of the gain from the involuntary conversions of Land was realized;
- 5) at the time P contributed to S the property it now wishes to purchase, P had no plan, intention, or binding commitment to reacquire such property from S with the conversion proceeds;
- 6) the real property which P proposes to purchase from S will qualify as property like kind to Land under section 1031;

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7) P intends to hold the property it proposes to purchase from S for investment or for productive use in a trade or business pursuant to section 1033(g)(1); and

8) the sale price of the property proposed to be purchased from S will reflect arms'-length dealing and fair market value based on an independent appraisal.

LAW

Section 1033(a)(2)(A) of the Internal Revenue Code provides, in part, that if property (as a result of requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph. If the taxpayer during the period specified in 1033(2)(b), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property. For the purposes of this subsection, the taxpayer shall be considered to have purchased property only if, but for the provisions of 1033(b), the unadjusted basis of such property would be its cost within the meaning of section 1012.

Section 1033(a)(2)(B) of the Code provides, in part, that the period referred to in 1033(a)(2)(A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending

- (i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or
- (ii) subject to such terms and conditions as may be specified by the Secretary, at the close of the such later date as the Secretary may designate on application by the taxpayer.

Section 1033(b) of the Code provides, in part, that in the case of property purchased by the taxpayer in a transaction described in section 1033(a)(2) which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the

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cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

Section 1033(c) of the Code provides, generally, that for the purposes of subtitle A, if property lying within an irrigation project is sold or otherwise disposed of in order to conform to the acreage limitation provisions of Federal reclamation laws, such sale or disposition shall be treated as an involuntary conversion to which section 1033 applies.

Section 1033(g)(1) of the Code provides, in part, that for purposes of section 1033(a), if real property held for productive use in trade or business or for investment is (as a result of requisition, or condemnation, or the threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Section 1033(g)(4) of the Code provides, generally, that in the case of a compulsory or involuntary conversion described in section 1033(g)(1), section 1033(a)(2)(B)(i) shall be applied by substituting "3 years" for "2 years."

Section 1.1502-12 of the regulations provides, in part, that the separate taxable income of a member of an affiliated group of corporations is computed under the provisions of the Code covering the determination of taxable income of separate corporations, subject to certain modifications. Under section 1.1502-80, the Code, or other law, applies to the group if the regulations do not exclude its application.

Section 1.1502-13(a)(1)(i) of the regulations provides, in part, that the term "intercompany transaction" means a transaction during a consolidated return year between corporations which are members of the same group immediately after such transaction. Thus, an intercompany transaction includes a sale of property by one member of a group to another member of the same group.

Section 1.1502-13(a)(2)(i) of the regulations provides, in part, that the term "deferred intercompany transaction" includes the sale or exchange of property.

Section 1.1502-31(a) of the regulations provides, in part, that the basis of property acquired by a purchasing member in a

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Section 1.1502-31(a) of the regulations provides, in part, that the basis of property acquired by a purchasing member in a deferred intercompany transaction shall be determined as if separate returns were filed.

Whether replacement property could be "purchased" within the meaning of section 1033 of the Code from a related party was addressed by the Service in Rev. Rul. 73-120, 1973-1 C.B. 369. The taxpayer was a utility company solely owned by A and B. When the taxpayer's assets were condemned, it purchased an apartment complex from A and B. After having determined the other requirements of section 1033(a)(3)(A) were satisfied, the ruling holds that because the taxpayer paid its sole shareholders an arm's length purchase price for the apartment complex, this replacement property was purchased as required by section 1033(a)(3)(A) (now 1033(a)(2)).

The Service held in Rev. Rul. 69-123, 1969-1 C.B. 199, that a taxpayer who sells real property pursuant to Federal reclamation laws within the meaning of section 1033(d) of the Code (now section 1033(c)), may replace the converted property with property of like kind within the meaning of section 1033(g)(1) of the Code. It further held that the replacement period begins with the date of the sale of the excess acreage and ends one year after the close of the first taxable year in which any part of the gain is realized, or at a later time as designated by the District Director upon application by the taxpayer.

The courts have denied taxpayers a cost basis determined under section 1012 of the Code in property that they have disposed of and later reacquired in certain situations. For example, in US v. General Geophysical Co., 296 F.2d 86 (5th Cir. 1961), rev'g, 175 F Supp 208 (S.D. Tex 1959), cert. denied, 369 U.S. 849, reh'g denied, 369 U.S. 891 (1962), the taxpayer redeemed the stock of two of its shareholders with corporate assets. Later that day, the corporation reacquired the assets by issuing notes to the former shareholders. The Court of Appeals denied the corporation a section 1012 basis in the assets because the corporation's ownership in the assets had not been interrupted. In substance, the transaction involved a redemption of the stock for notes and the assets in question never left the taxpayer.

The taxpayer in Seattle Hardware Co. v. Squire, 83 F Supp 106 (W.D. Wash. 1948), aff'd, 181 F.2d 188 (9th Cir. 1950), was also denied a stepped-up basis in property that it had reacquired from its wholly owned subsidiary. The court determined that the existence of the subsidiary lacked substance. Although the incorporators had filed the Articles of Incorporation, the

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money was contributed to the subsidiary and no stock was issued. Although on paper, the subsidiary owned the property in issue, the taxpayer actually paid the purchase price, constructed the improvements, and paid all taxes and insurance on the buildings. In substance, the property was owned by the taxpayer at all times.

Similarly, in Thal v. Commissioner, the taxpayer was not entitled to a section 1012 basis for stock that he had reacquired after having contributed the stock in payment of a debt. The securities were worth less than the amount of the debt and were never delivered to the taxpayer. The taxpayer at all times kept and enjoyed the benefits of ownership in the stock.

On the other hand, a transaction involving a bona fide sale for consideration and a subsequent repurchase will be respected for tax purposes. In Atkins v. Commissioner, 28 B.T.A. 500, aff'd, 76 F.2d 387 (5th Cir. 1933), acq., XII-2 C.B. 2, the taxpayer was entitled to a cost basis under section 1012 when it repurchased stock from the decedent's sister. The court determined the prior transfer to the sister was a bona fide sale for valuable consideration.

#### ANALYSIS

Generally, section 1033 of the Code allows a taxpayer whose property is involuntarily converted to defer the recognition of the gain if the taxpayer makes a proper and timely election to defer the gain and purchases qualifying replacement property within the specified time period for the purpose of replacing the converted property. If real property was condemned and had been held for use in a trade or business or for investment, the property must be replaced by like kind property within three years following the year in which any part of the gain was realized. P represents that its real property was involuntarily converted within the meaning of sections 1033(c) and 1033(g). This property was held for use in a trade or business or for investment and the proposed replacement property is like kind to the converted property. P also represents that it has timely and properly elected to defer the gain under section 1033 and the converted property would be replaced within the 3 year replacement period.

The facts and representations present two issues: 1) whether P has "purchased" the replacement property, and 2) whether the property sold pursuant to the Federal reclamation laws is or will be timely replaced? There are two relevant questions within the first issue concerning whether P "purchased" the replacement property: 1) whether a repurchase of property by P who had previously disposed of it, can qualify as a purchase

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the replacement property: 1) whether a repurchase of property by P who had previously disposed of it, can qualify as a purchase within the meaning of section 1033(a)(2) of the Code; and 2) whether a purchase from a related party, a wholly owned subsidiary, can qualify as a purchase within the meaning of section 1033(a)(2)?

Section 1033(a)(2)(A) of the Code sets forth the applicable standard for the first determination. The taxpayer shall be considered to have purchased property only if, but for the provisions of 1033(b), the unadjusted basis of such property would be its cost within the meaning of section 1012. Taxpayers have been denied a cost basis in repurchased property previously disposed of by the taxpayer when the courts have found that the taxpayer's ownership in the property was never interrupted by the disposition and reacquisition. The case at hand does not present a factual situation like General Geophysical where the taxpayer had redeemed two of its shareholders with corporate assets and later that same day repurchased the assets with promissory notes. Here, S has held the proposed replacement property for almost two years and P has represented that at the time of the contribution to S, it had no intention, plan, or binding commitment to reacquire the property from S with the conversion proceeds.

Nor do the facts resemble the facts in Seattle Hardware where the court determined that the subsidiary formed by the taxpayer and proposed to have owned the property in question lacked substance. In this case, S was formed for business reasons unrelated to the involuntary conversions and issued stock to P in exchange for the property that P contributed to it. The contributed property was selected and approved of by Partnership C to satisfy Partnership C's requirements concerning their unrelated transaction. The stock received by P was pledged to Partnership C. These facts indicate that the subsidiary's existence had substance and it owns or owned the replacement property. The facts are equally distinguishable from those in Thal where the taxpayer transferred but never delivered stock in payment of an existing debt whose face value was greater than the value of the stock. The taxpayer in Thal later reacquired the stock. Here, the property was contributed as a contribution of capital and not as a payment of a personal debt, and title was delivered to the subsidiary. Because the facts surrounding the taxpayer's repurchase reflect an arm's length transaction, there is no reason to challenge it as a non-bona fide transaction.

P's purchase of qualifying assets from S will constitute a deferred intercompany transaction. Thus, section 1.1502-13(c)(1) of the regulations regarding the deferral of any recognized gain in a consolidated return year by the selling member will apply. Additionally, but for the provisions of section 1033(b) of the



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Code, the basis of the property acquired by P will be its cost under sections 1012 and 1.1502-31(a).

The second purchase question is whether P's purchase from its subsidiary should be respected for purposes of section 1033(a)(2) of the Code. The issue can be resolved by looking at Rev. Rul. 73-120, 1973-1 C.B. 369. That ruling concludes that the taxpayer satisfied the purchase requirement when it purchased the replacement property from its shareholders at an arm's length purchase price. In this case, P has represented that the sale price of the proposed replacement property will reflect arm's-length dealing and fair market value based on an independent appraisal. The purchase contract will also contain the standard representations, warrants, and covenants normally found in a contract between unrelated parties. In addition, the promissory note, representing █% of the purchase price, will have all the attributes of a purchase money instrument issued between unrelated parties. Therefore, we conclude on the basis of the represented facts that P will satisfy the purchase requirement under section 1033(a)(2).

The last issue to address pertains to the replacement period of property sold pursuant to the Federal Reclamation Laws under section 1033(c) of the Code. Rev. Rul. 69-123 concludes that the taxpayer may replace the converted property with like kind property but must replace it within one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at some later date as designated by the District Director upon application for an extension pursuant to section 1.1033(a)-2(c)(3) of the regulations. This "one year" period was the standard replacement period for all types of involuntary conversions at the time the revenue ruling was published. Since that time, Congress has amended section 1033(a)(2)(B) and 1033(g) to extend the "one year" period to a "two year" period for all involuntary conversions except those involving real property held for productive use in trade or business or for investment which are converted as a result of requisition, or condemnation, or the threat or imminence thereof. For those types of involuntary conversions, the period was extended to a "three year" period. See, section 1033(g)(4). Because Rev. Rul. 69-123 has extended the "like kind" standard of section 1033(g) to involuntary conversions resulting from the sale of real property pursuant to Federal reclamation laws, it is equally appropriate to apply the "three year" period of section 1033(g)(4) to these types of involuntary conversions. Therefore, we conclude that P will or has timely replaced the property converted pursuant to the Federal Reclamation Laws if P replaces the converted property within three years after the close of the first taxable year in which any part of the gain was realized.

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HOLDINGS:

Based upon the facts and representations as submitted by P and provided that the contribution of the property to S and the repurchase of those properties do not constitute a single transaction, the following rulings are provided:

- 1) the proposed purchase by P of real property from S will constitute the purchase of qualified replacement property pursuant to sections 1033(a)(2)(A) and (g);
- 2) pursuant to section 1033(a)(2)(A), gain will be recognized by P only to the extent that the amount realized upon the involuntary conversion of Land exceeds the cost of such replacement property as it applies to each parcel of Land converted;
- 3) P's basis in the acquired replacement property will be its cost as determined under section 1012 of the Code and section 1.1502-31(a) of the Treasury Regulations, as adjusted by section 1033(b);
- 4) the sale of property by S to P will constitute a deferred intercompany transaction under section 1.1502-13(a)(2)(i) of the Treasury Regulations.